

# THE PRIVACY REQUIREMENT RECONSIDERED

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## I. INTRODUCTION

The traditional version of the law of lawyer liability says that a lawyer is liable only to those with whom the lawyer is in "privity." As a practical matter, this limits the lawyer's liability to clients because it is only with clients that a lawyer is in privity. The notion of privity has lost its place as a limitation on liability in practically all spheres of tort liability except that of lawyer malpractice.<sup>1</sup> Even in the law of legal malpractice, the privity requirement is now shot through with exceptions that render it unintelligible and hence unworkable as a legal concept.

The concept nevertheless has held on.<sup>2</sup> Its remaining vitality appears partly the result of anxiety in the bench and bar about imposing

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1. See, e.g., W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS, § 93, at 667-68, § 96, at 681-83 (5th ed. 1984).

2. See, e.g., *Espinosa v. Sparber, Shevin, Shapo, Rosen & Heilbronner*, 612 So. 2d 1378, 1379 (Fla. 1993) (holding liability is limited to clients in privity with attorney); *Schreiner v. Scoville*, 410 N.W.2d 679, 681 (Iowa 1987) (holding privity rule applies absent special circumstances such as fraud or collusion); *Hatbob v. Brown*, 575 A.2d 607, 613 (Pa. 1990) (holding attorney-client relationship "essential" in legal malpractice claim); *Barcelo*

liability too readily on those who practice law. This anxiety is understandable inasmuch as law practice often involves measures that conflict with widely held conventional moral precepts. The practice of law involves partisanship that is repugnant to commonly shared concepts of social equality.<sup>3</sup> It often involves measures on behalf of clients that are very hard on others. Judges and lawyers know that such measures do not sit well with many jurors and know also that a case that comes within the liability rules goes to the jury, usually to be decided according to commonly shared concepts of social morality. Hence, there remains a strong attraction to the immunizing effect of the privity requirement.

Privity survives also because, in contemplating legal malpractice, judges and lawyers readily bring to mind the role of the barrister, *i.e.*, the trial advocate. Trial advocacy involves intense partisanship, such that many lawyers, let alone jurors, consider it to be repugnant. It also involves the hardest of hard measures: imposing on the losing party an involuntary disposition dictated through the rule of *res judicata*, often in the face of evidence sufficiently ambiguous as to involve a genuine issue of fact.<sup>4</sup> If there were legal malpractice liability in favor of the losing party in litigation, it is rightly feared that there would be no end to litigation.<sup>5</sup>

The problem of legal malpractice liability for conduct in litigation, however, is quite distinct from the problem of liability of the transaction lawyer. As a point of departure, in general a coherent distinction can be drawn between the functions of the litigation lawyer and the transaction lawyer. Thus, the activities in these two branches of our profession are empirically distinct. It is possible to formulate rules governing the functions of transaction lawyers that would not sweep within their terms the functions of litigation lawyers. For another thing, most law practice consists of transaction matters, not litigation. It would surely be bizarre to preserve a severe limitation on

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v. Elliott, 923 S.W.2d 575, 579 (Tex. 1996) (holding privity rule bars claim by beneficiaries for negligently prepared estate planning documents).

3. See, e.g., Charles Fried, *The Lawyer as Friend: The Moral Foundations of the Lawyer-Client Relation*, 85 YALE L.J. 1060, 1067-68 (1976) (discussing the compatibility between the traditional conception of the lawyer's role and the ideal of moral purity).

4. See FLEMING JAMES, JR. ET AL., *CIVIL PROCEDURE* § 7.21 (4th ed. 1992). All lawyers know how galling to a client it is to lose to an opposing party that the client believes is simply a liar.

5. Well, there might be an end to litigation, if only because no lawyer would take the risk of undertaking it. That in turn would be bad for the judges, who then would have to hear all cases presented *in propria persona*.

liability of lawyers doing transactions out of concern for liability of lawyers doing litigation.

More fundamentally, transaction lawyers function in "real time," as actors in the real world. As such they create real and irreversible events. They deal in buying and selling, borrowing and lending, conveyancing, divorcing, etc. Litigation lawyers, in contrast, usually function in the slow, arrested time phase of the litigation process, under the close scrutiny of an adversary and under the more or less careful scrutiny of the judges. They are engaged in creating, through the trial process, a more or less accurate replica of the real world events from which the litigated dispute arose. The version of reality thereby created is artificial and, so long as the right of appeal remains open, reversible. In contrast, the work of the transaction lawyer will come to the attention of judges only occasionally and in retrospect. And it can be brought to the attention of judges only at the price of new and large transaction costs that are entailed in litigation. These differences suggest that a different set of rules is appropriate for the transaction lawyer compared with the litigation lawyer.

Accordingly, this presentation addresses the legal responsibilities of transaction lawyers. It could go without saying that a transaction lawyer is liable for intentional or negligent injury inflicted on the lawyer's client. Liability of lawyer to client is usually very fact-specific and in any event has been well stated by leading text writers.<sup>6</sup> My focus is on liability to persons other than the client.

## II. LIABILITY TO NONCLIENTS: AN OVERVIEW

The general propositions to be developed are as follows:

- (1) The privity rule taken at face value is too restrictive a limitation on liability of transaction lawyers, as the courts have well recognized; hence, it has been necessary to develop "exceptions" to the privity rule.
- (2) However, the exceptions are amorphous and therefore unpredictable in their implications to lower courts and to appellate judges in later cases, to say nothing of their ambiguity from the viewpoint of practicing lawyers.
- (3) The privity rule with exceptions is structurally flawed because it focuses on the wrong end of the transaction, *i.e.*, where the transaction begins with lawyer and client rather

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6. See, *e.g.*, RONALD E. MALLIN AND JEFFREY M. SMITH, *LEGAL MALPRACTICE* §§ 19.1-27 (3d ed. 1989); *RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS* § 28 (Tentative Draft No. 5, 1992).

than with the nature of the transaction and where it ends in the ensuing consequences.

- (4) Finally, a more intelligible and functionally more coherent approach is through the law of agency, recognizing that a transaction lawyer is agent for the client as principal.

This approach has the additional virtue of implicitly assimilating lawyers to other agents, such as real estate brokers, sales representatives, investment bankers, and accountants. Assimilating lawyers to other agents reduces the risk that lawyers will be given a place that is either preferred in the law governing liability of professionals or one that is disadvantaged. Put crudely, such an assimilation poses the question: If a used car dealer should not get away with a particular maneuver or omission, why should a lawyer be able to do so?

There have been several bases for recognizing liability of transaction lawyers to third persons despite the limitations imposed by the privity requirement. A principal one results from the expansion of the concept of misrepresentation.

### III. FRAUD

It has long been settled that a lawyer can be held liable for fraud to a person who is not his client.<sup>7</sup> One or two courts, notably the Fourth Circuit in *Shatz v. Rosenberg*,<sup>8</sup> have had difficulty accepting this proposition.<sup>9</sup> If the converse of the proposition is recognized, however, the result seems inevitable. Can the law really say that transaction lawyers, alone among all participants in property and financial transactions, are immune from liability for fraud? That proposition is surely insupportable. If it is insupportable, then a lawyer has to be liable for committing fraud on a third person, or for assisting a client in committing a fraud.

The inquiry then proceeds to further questions. What is meant by "fraud?" It used to be the law that fraud consisted of statements of fact, as distinct from opinion, known to be false by the person making the statement, which were material to the transaction, and that induced justifiable reliance by the third person. Each of these was an element of a cause of action for a person who had been gulled into

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7. See generally MALLEN & SMITH, *supra* note 6, § 6.4 (noting an attorney can be held liable to a nonclient, even an adversary in litigation, for fraud or deceit); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 42, cmt. c (Tentative Draft No. 5, 1992) & ch. 4 (forthcoming 1997) (citing cases where an attorney has been held liable for fraud to a nonclient, such as the Internal Revenue Service).

8. 943 F.2d 485 (4th Cir. 1991).

9. See *id.* at 492-94.

parting with his money or property. A statement of "fact" was contrasted with "mere puffing" or a statement of opinion. The requirement that the representation be knowingly false left it open to the defendant to say that he really believed the statement, or at least that he did not know it was false. The requirement of materiality left room to argue that the misrepresentation concerned a merely collateral matter, one not going to the essence of the transaction. The requirement that reliance be justifiable was a basis on which a jury or the judges could say that the victim got what he deserved because the law cannot protect the foolish.<sup>10</sup>

All this has changed, slowly but inexorably. The transactions in modern society no longer are limited to the sale of real estate and horses, which are tangible and visible and have characteristics that could plausibly be regarded as having been within everyone's ordinary knowledge. Today, ordinary people trade in intangible interests (stocks, bonds, futures, options and "derivatives" of more or less exotic types), and in intangible entities (corporate enterprises and joint ventures, etc.), on the basis of information from sources with which no one could become personally familiar. The information revolution has therefore required change in the rules governing the responsibilities of purveyors of information and those who assist them.

The change could be said to have been marked with the Securities Acts of 1933 and 1934, and is reflected in other legislation requiring disclosures in various types of transactions—for example, consumer loans and residential real estate developments.<sup>11</sup> The effect of these legislative changes is to transform the burden of truth-telling from that of avoiding demonstrable falsehood to providing fair and adequate disclosure. Under typical legislation, in the words of Rule 10b-5, it is now fraud "to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."<sup>12</sup>

The common law is evolving to the same point. Fraud, more gently called misrepresentation, now includes not only positive falsehoods, but statements that are misleading when taken as a whole and

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10. KEETON ET AL., *supra* note 1, § 108, at 749-50. It seems not amiss here to quote from accepted black letter. The *Restatement (Second) of Agency* states "[a]n agent who fraudulently makes representations, uses duress, or knowingly assists in the commission of tortious fraud or duress by his principal or by others is subject to liability in tort to the injured person although the fraud or duress occurs in a transaction on behalf of the principal." RESTATEMENT (SECOND) OF AGENCY § 348 (1958).

11. See Regulation Z, 12 C.F.R. §§ 226.1-30 (1995) (detailing disclosure requirements for loan and consumer credit transactions under the Truth in Lending Act).

12. 17 C.F.R. § 240.10b-5 (1993).

under the particular circumstances. It includes not only statements that the declarant knows to be misleading but also statements that, given the declarant's access to facts, the declarant may be inferred to have realized were misleading. In addition, it includes not only statements of "facts," but also opinions of a definite sort, particularly opinions inconsistent with facts known or available to the declarant. It encompasses not only matters "material" in the old strict sense, but also matters that an ordinary person (*i.e.*, a juror) would think are significant. In other words, fraud no longer encompasses merely statements that would induce reliance justifiable in the mind of a Victorian judge, but those upon which it is reasonably foreseeable that an ordinary person would rely (*i.e.*, again a juror).<sup>13</sup>

The requirements of disclosure, whether imposed by statute or by common law, have become correspondingly exacting. Statutory disclosures generally must follow highly specific formats.<sup>14</sup> Disclosures required by the common law are not tightly specified but require correspondingly greater legal circumspection, that is, informed estimates of the kind and quality of detail that will eventually satisfy a jury, if it comes to that. Compliance with statutory disclosure requirements therefore requires technical legal knowledge of the details of those requirements, and compliance with the common law requires good practical legal judgment. Since lawyers are best equipped to supply the requisite technical knowledge and legal judgment, their participation becomes a practical necessity in financial and commercial transactions that are either, in an instance, large in scale or done on a mass production basis.

The positive aspect of lawyer participation is that lawyers become gatekeepers—that is, positioned to disallow transactions that do not meet the applicable disclosure requirements.<sup>15</sup> The negative aspect of lawyer participation is that lawyers who neglect their gatekeeper roles become accessories to fraud. It is this relationship that moved Judge Henry Friendly to say in *United States v. Benjamin*,<sup>16</sup> that "[i]n our complex society the accountant's certificate and the lawyer's opinion

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13. See KEETON ET AL., *supra* note 1, § 108, at 753–54.

14. See, e.g., 15 U.S.C. § 1637 (1994) (credit cost disclosure requirements in open-ended credit arrangements); 12 C.F.R. § 226.18 (1995) (listing required disclosures under Truth in Lending Act including itemization of amount financed, finance charge, annual percentage rate, probability of increases if variable interest rate, payment schedules, and disclosure of any security interest held by creditor).

15. See Reiner H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 888–89 (1984).

16. 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964).

can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar."<sup>17</sup>

These developments in the law of misrepresentation now converge on the activities of transaction lawyers. A leading case is *Greycas, Inc. v. Proud*,<sup>18</sup> decided almost a decade ago. In that decision, Judge Posner helpfully mapped the relationship between the privity requirement and the law of negligent misrepresentation. He upheld liability of a lawyer who said to a lender that the lawyer had done a "due diligence" inquiry concerning UCC filings on farm equipment, but who in fact, rather than making an inquiry himself, had relied on an assurance by the borrower that there were no liens on the equipment.<sup>19</sup>

A very recent decision, this one by the New Jersey Supreme Court, traces the more recent legal development and also upholds liability based on misrepresentation. In that case, *Petrillo v. Bachenberg*,<sup>20</sup> the lawyer for a seller of property provided the reports concerning the capacity of the land to sustain a septic drainage field.<sup>21</sup> These days, environmental regulations make land virtually unsalable unless it has the necessary drainage capacity, so the information was clearly material. The reports are called "perc" tests, referring to capacity for percolation. The lawyer provided the buyer with several perc test reports that were positive, but failed to provide many others that were negative.<sup>22</sup> This selective truth-telling was held to be misrepresentation, and as such a basis of liability to the buyer, who of course was a nonclient.<sup>23</sup> We may note here the convergence of a new legal requirement concerning the underlying transaction, *i.e.*, environmental regulation, with a newly enhanced requirement of truthfulness in the transaction itself.

More generally, transaction lawyers these days are required in a wide variety of circumstances to provide statements of facts to people who are not their clients but who, it is expected and foreseeable, will rely on the statements.<sup>24</sup> This is what "due diligence" work is all about. After some meandering, the law appears to be settling into the

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17. *Id.* at 863.

18. 826 F.2d 1560 (7th Cir. 1987), *cert. denied*, 484 U.S. 1043 (1988).

19. *Id.* at 1565-66.

20. 655 A.2d 1354 (N.J. 1995).

21. *Id.* at 1356.

22. *Id.*

23. *Id.* at 1362.

24. See *Prudential Ins. Co. of Am. v. Dewey, Ballantine, Bushby, Palmer & Wood*, 605 N.E.2d 318, 322 (N.Y. 1992) (stating that a lawyer owes a duty to a nonclient when a sufficient nexus exists between the two parties).

following pattern: A lawyer is liable to a person not his client to whom the lawyer makes statements that, taken as a whole, are materially false or misleading, where the addressee or recipient is a specific person or in a definable set of persons who, it can be reasonably foreseen, are likely to rely on the statements; and the making of the statements does not conflict with lawful purposes of the lawyer's client but, if done honestly and competently, are in furtherance of such purposes. "Lawful purposes" does not include misleading the nonclient in a way that would be tortious if the statements were made by the client.

#### IV. ASSISTING WRONGFUL ACTS OF AGENTS OF THE CLIENT

A related but distinguishable situation of lawyer liability involves misrepresentations on behalf of someone who looks and acts like a client but who is not, properly speaking, a client. I refer here to the situation of lawyers representing corporations and other entities who proceed on instruction from corporate officers or managers of the organization. When the conduct of a corporate officer or employee exposes the corporation to liability, the lawyer can be liable for failing to protect the client, that is, the organization. Here, a prototypical situation is found in *FDIC v. O'Melveny & Myers*.<sup>25</sup>

The *O'Melveny* case came up on demurrer, so we have only allegations concerning the supposed facts. The allegations were as follows: The law firm represented a bank in connection with a securities issue that was based in part on financial statements disseminated by the bank.<sup>26</sup> The law firm performed "due diligence" in connection with the disclosure documents in selling the securities issue.<sup>27</sup> The financial statements set forth in the disclosure documents in turn were based on affirmations by bank officers about the financial condition of the bank.<sup>28</sup> The affirmations were false; and, so it was alleged, the law firm had failed to follow accepted practice in due diligence by failing to make inquiry of the accounting firm that audited the bank as to accuracy of the figures provided by the bank officers.<sup>29</sup>

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25. 969 F.2d 744 (9th Cir. 1992), *rev'd*, 114 S. Ct. 2048 (1994), *modified*, 61 F.3d 17 (9th Cir. 1995).

26. *Id.* at 746.

27. *Id.* at 746-47.

28. *Id.* at 746.

29. *Id.* at 747.



Many of the cases arising from the savings and loan crisis follow this pattern.<sup>30</sup> That is, the claim is prosecuted by the FDIC or the Resolution Trust Corporation as corporate successor to the corporate client. The charge against the lawyer or law firm is that of neglect of duty to the *client* corporation in that the lawyer deferred to the wishes and instructions of the corporate officials.<sup>31</sup> Here, there is no lack of privity because the claim is in the right of the client. At least since 1983, this concept should have occasioned no surprise to practicing lawyers. In that year, the American Bar Association adopted the Model Rules of Professional Conduct, and therein Rule 1.13. Rule 1.13 was drafted with the guidance of an ad hoc committee of the ABA Section of Business Law, a committee that I can attest was certainly not “anti-lawyer.” To the contrary, the formulation in Rule 1.13 sets forth principles of professional responsibility that are implied by the law of corporations, by the law of agency, and by the resulting proposition that a corporation is entitled to have faithful legal representation.<sup>32</sup>

On this basis, Rule 1.13 recognized that “[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.”<sup>33</sup> This proposition is a truism if it is assumed, as every lawyer has assumed, that a corporation may employ a lawyer to represent the entity. From this truism, it follows under principles of agency law that corporate directors, officers, managers, and employees are not clients but agents of the client, and directors are fiduciaries for the client. It also follows under principles of agency law that those agents have duties of care and of loyalty to the corporation—duties that parallel the lawyer’s own duties to the corporation. It further follows that because corporate agents, like other agents, can be careless or faithless, the corporate agents may violate their duties to the corporation. When such a violation occurs,

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30. See, e.g., *FDIC v. Wise*, 758 F. Supp. 1414, 1418–19 (D. Colo. 1991) (denying attorney’s motion to dismiss and concluding facts might support claim that attorneys owed duty to advise and investigate into client savings and loan’s improper activities).

31. A fact-specific application of this principle is set forth in *In re American Continental Corp./Lincoln Sav. & Loan Sec. Litig.*, 794 F. Supp. 1424, 1453 (D. Ariz. 1992). There remains in some minds an unfortunate confusion as to the identity of the client of a lawyer for a corporation. See, e.g., Robert A. Desilets, Jr., *The Model Rules of Professional Conduct and the Securities Attorney: Confidentiality, Confusion and the Need for Change*, 23 CAP. U. L. REV. 611, 637–38 (1994) (arguing that the duty of confidentiality to corporate officer supersedes duty of loyalty to corporation).

32. The proposition was earlier recognized in the American Bar Association MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 5-18 (1981).

33. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(a) (1995).

the question arises as to how the lawyer should proceed. More specifically, the question is, "To whom does the lawyer's duty run?"

The answer to this question, given the premises stated above, is inevitable—the lawyer's duty is to the corporation.<sup>34</sup> The same analysis applies when the client is some other kind of organization, such as a partnership or unincorporated association. Rule 1.13 spelled out the implications that then ensue. Rule 1.13(b) provides as follows:

If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization.<sup>35</sup>

The key terms here are "knows," "violation of a legal obligation to the organization," "violation of law which reasonably *might be imputed* to the organization," "substantial injury to the organization," and "best interest of the organization."<sup>36</sup>

The requirement of knowledge is a basis for disciplinary liability. However, the very concept of a malpractice action by a client is the failure of the lawyer to use reasonable care in the service of the client. Reasonable care includes taking reasonable affirmative precautions to ascertain facts relating to the representation. Accordingly, for purposes of liability to the corporation—as distinct from a disciplinary violation—the standard concerning knowledge on the part of the lawyer is "knows or should know."

The reference to violation of legal obligation "to" the organization obviously refers primarily to obligations owed by agents of the corporation under the principles of agency law. Agents of the corporation notably include officers and other high and middle level managerial employees, that is, the types of corporate officials and employees with whom lawyers ordinarily interact. An obvious example of a violation by a corporate agent of his duty to the organization is an officer who is embezzling from the company. A less obvious example is that in the *O'Melveny* situation, where the officers

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34. See *Yablonski v. United Mine Workers*, 448 F.2d 1175, 1182 (D.C. Cir. 1971) (disqualifying lawyer to corporate client due to representation of president of corporation in individual capacity), *cert. denied*, 406 U.S. 906 (1972). The *Yablonski* case involved litigation, which makes the point that litigation lawyers sometimes can confront problems similar to those confronted by transaction lawyers.

35. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(b) (1995).

36. *Id.* (emphasis added).

breached their duty to provide accurate information for a securities offering statement that was to be promulgated by the corporation.<sup>37</sup> Perhaps it need not be added that in these days of hyper-regulation, there are all kinds of legal duties of a corporation that by implication require responsible officers and other employees to see that the corporation complies with the law.<sup>38</sup>

The reference in Rule 1.13 to violations of law that "might be imputed" to the corporation is a parallel predicate of the duties under agency law that have just been referred to. That is, the corporation is burdened by manifold legal duties which corporate officials and employees must see are fulfilled. The corporate managers as agents are in jeopardy of violating their legal duties to the corporation precisely because their action or inaction can result not only in loss of profit or other mismanagement, but also in the corporation being subjected to legal liability. An obvious example is price-fixing that may have immediate benefit to the corporation but that also exposes the corporation to anti-trust liability. Another example is bad bookkeeping that violates the Foreign Corrupt Practices Act.<sup>39</sup> Another is action or inaction of officers that exposes the company to liability under the Securities Acts, which was the situation alleged in the *O'Melveny* case.

Liability of the corporation, as the client, for illegal acts by its directors, officers and other managers arises in small companies as well as large ones. Indeed, from the viewpoint of a lawyer for a corporation, the problem is more difficult in the case of closely held corporations. For one thing, in these relationships the lawyer may well have come to represent not only the corporation as such, but also its principal managers and investors.<sup>40</sup> Among other things, the dual representation poses serious issues of conflict of interest on the part of the lawyer when the chief executive officer or the manager proposes a course of conduct that arguably is a violation of the duties referred to in Rule 1.13. Even if the lawyer has not become engaged in represen-

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37. *FDIC v. O'Melveny & Myers*, 969 F.2d 744, 748-49 (9th Cir. 1992), *rev'd*, 114 S. Ct. 2048 (1994), *modified*, 61 F.3d 17 (9th Cir. 1995).

38. See A.L.I. *PRINCIPLES OF CORPORATE GOVERNANCE* § 2.01 (1994) (suggesting that corporations must act within the boundaries of the law).

A well known case, *Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C.*, 309 N.W.2d 645 (Mich. Ct. App. 1981), whose rationale eluded both the court deciding it and those who have since reflected on it, can be subsumed under the proposition that a lawyer may not assist a corporate officer in conduct that is a legal violation by the corporation. In that case, the senior doctor in a close medical corporation was assisted by the company's lawyer in damaging the junior doctor's professional standing. *Id.* at 647, 649 n.8.

39. 15 U.S.C. §§ 78dd-1, dd-2 (1994).

40. See *In re Brownstein*, 602 P.2d 655, 657 (Or. 1979).

tation of the principals personally, however, he will necessarily have had a relatively intimate personal relationship with them.

An especially intricate variation of the problem arises in bankruptcy representation, particularly in two types of situations. One is where a small company is going under financially and the principal owner-manager tries to salvage what is left of his investment by diverting corporate assets to a trust, to his wife, or to a Swiss bank account. These transactions are known as voidable preferences or even fraudulent transfers.<sup>41</sup> A creditor or successor management appointed in the bankruptcy proceeding can sue for restoration of the assets or their value, not only against the owner-manager but against others who have helped effectuate the conveyances.<sup>42</sup> Those who provided that help can include the lawyer for the corporation.

The other recurrent bankruptcy situation is where the corporation enters Chapter 11 reorganization. Here, the management continues in office but is clothed with new legal duties in the form of fiduciary responsibility to creditors.<sup>43</sup> Management typically chooses Chapter 11 rather than "straight" bankruptcy precisely because Chapter 11 allows the managers to continue running the company. Managers tend to interpret the concept of "continue" to mean "in the same way," except with more intensity. But being in Chapter 11 is a legal transformation of management's role. Transactions and decisions that previously were required to comply only with the protective standard of the business judgment rule must now also pass muster under the more exacting standard of fairness to creditors. The obligation to maximize stockholder gain, which is the objective protected by the business judgment rule, can be in conflict with the obligation to be fair to creditors. This narrows the channel of legality through which management must pass.

By the same token, the heightened duties of management in a Chapter 11 proceeding expose the lawyer to heightened attentiveness to fulfilling his duties as outlined in Rule 1.13. Failure to be attentive in this respect can result in malpractice liability to the corporation.<sup>44</sup>

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41. See UNIFORM FRAUDULENT TRANSFER ACT § 4 (1994).

42. See 11 U.S.C. § 550 (1993).

43. See 11 U.S.C. § 1107 (1994) (requiring debtor-in-possession to perform functions and duties of bankruptcy trustee).

44. See *McElhanon v. Hing*, 728 P.2d 256, 264-66 (Ariz. Ct. App. 1985) (holding attorney liable as co-conspirator in fraudulent conveyance), *aff'd in part and vacated in part on other grounds*, 728 P.2d 273 (Ariz. 1986), *cert. denied*, 481 U.S. 1030 (1987); *Durant Software v. Herman*, 257 Cal. Rptr. 200, 208 (Ct. App. 1989) (holding attorney who furthered conspiracy to defraud creditor not immune from liability merely because he acted in the capacity of attorney); *cf. United States v. Brown*, 943 F.2d 1246, 1252-53 (10th Cir.

The liability to which corporate lawyers are thus exposed is not an exception to the privity rule. On the contrary, liability to the corporate client for failure to act in its best interests, when it was threatened with misfeasance or malfeasance of its agents, is the essence of privity liability. Although the foregoing is clearly the law, there is a discrepancy between the structure of the law in this respect and the natural image of the human relationships involved. Failure to recognize this discrepancy is the root of most of the problems of lawyer liability in representation of corporations and other organizations.<sup>45</sup>

## V. LEGAL PRIVACY AND "NATURAL" PRIVACY

The natural image of privity is conveyed by those classic prints one sees in law offices of an old-fashioned solicitor consulting with a client who is a gentleman owner of landed property in rural England. An American variation is Abraham Lincoln consulting with a widow. In the *O'Melveny* case and others like it, however, the people from whom the lawyer took instruction were not the client, which was the corporation, but officers or employees of the client. Moreover, the malpractice claim is typically not brought at the behest of the people with whom the lawyer has done the transaction. Instead, the suit is brought by their successors as officials of the client, individuals who typically are previously unknown to the lawyer and are now hostile to the former managers with whom the lawyer had dealt.<sup>46</sup> In terms of interpersonal relationships, as distinct from legal relationships, there is no more "privity" between the law firm and the successor officials

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1991) (finding fraud when documents were destroyed and assets concealed). *But see* *Galant v. Kanterman*, 603 N.Y.S.2d 315, 318 (App. Div. 1993) (holding remedy for fraudulent conveyance does not include damages liability).

Such also was, in essence, the situation in *O'Melveny & Myers*, inasmuch as the S&L was apparently in serious financial trouble at the time the law firm was called upon to assist in raising new money. *See O'Melveny*, 969 F.2d at 746.

45. *See* Robert C. Horgan, Note, *Making Black and White Out of Gray: An Attorney's Duty to Investigate Suspected Client Fraud*, 29 NEW ENG. L. REV. 795, 803-05 (1995).

It is useful to recall that a general principle of agency law requires an agent not to act on behalf of another in a manner adverse to the interests of his principal. *Restatement (Second) of Agency* states, "[u]nless otherwise agreed, an agent is subject to a duty to his principal not to act on behalf of an adverse party in a transaction connected with his agency without the principal's knowledge." *RESTATEMENT (SECOND) OF AGENCY* § 391 (1958).

Within this formulation, another agent of the principal, *e.g.*, a corporate officer of a corporation, if acting adversely to the corporation's interest, is an "adverse party" vis à vis the corporation.

46. *See, e.g.*, *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 345-47 (1985) (dealing with control of attorney-client privilege by successor management).

than there is between the law firm and complete strangers. In legal terms, however, privity exists that fully accords with the strict definition.

Transaction lawyers may succumb to allowing the interpersonal relationship with corporate officials to dominate the lawyer's legal relationship to the corporate client. The discrepancy between the legal relationship and the personal relationship imposes an onerous burden on the lawyer. When the client is a corporation, a lawyer must regard the corporate officials as something in the way of strangers, while at the same time maintain with those people something in the way of a lawyer-client relationship. The failure to maintain this distinction, in practice as well as concept, is a pathway leading many lawyers to grief. In interpersonal terms—that is, in terms of the realities of human relationships in law practice—malpractice liability to successor management of a corporate entity thus amounts to another exception to the old privity rule.

Present-day corporation lawyers lament the terrible tensions in which they find themselves when trying to reconcile their legal duty to the corporate entity with their personal affiliations with corporate management. The often unspoken governing premise is that corporate management is in a position to discharge a lawyer if the lawyer gives management too hard a time. This personal endangerment is most serious for the in-house lawyer, whose entire financial capital, and perhaps his intellectual capital as well, is bound up in the corporation. The remedy of damages for wrongful discharge of an employee-lawyer, although now gaining recognition,<sup>47</sup> is hardly sufficient as a practical matter. A "whistle blower" lawyer is likely to be black-listed and can find new employment only at a geographical or social distance. An independent law firm that is fired for giving unwelcome advice has virtually no legal remedy. Nevertheless, in my view these are burdens that go with the office of being a lawyer and always have gone with the office. It is worth remembering Elihu Root's dictum that "[a]bout half the practice of a decent lawyer consists in telling would-be clients that they are damned fools and should stop."<sup>48</sup>

It is also worth remembering the words of the United States Court of Appeals for the District of Columbia, authored I believe by Carl McGowan (the opinion is *per curiam*), himself a former corpo-

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47. See, e.g., *General Dynamics Corp. v. Superior Court*, 876 P.2d 487, 490 (Cal. 1994) (allowing damages in an employee-lawyer wrongful discharge claim); *GTE Prods. Corp. v. Stewart*, 653 N.E.2d 161, 166-67 (Mass. 1995) (allowing wrongful discharge remedy for in-house counsel under narrow circumstances).

48. PHILIP C. JESSUP, ELIHU ROOT 133 (1938).

rate lawyer, and concurred in by Malcolm Wilkey, also a former corporate lawyer:

Certainly no corporate counsel purports to represent the individual officers involved, neither in the particular [matter] nor in other [matters] by virtue of which counsel necessarily must create ties of loyalty and confidentiality to the individual officers, which might preclude counsel from the most effective representation of the corporation itself. The corporation has certain definite institutional interests to be protected, and the counsel charged with this responsibility should have ties on a personal basis with neither the dissident stockholders nor the incumbent officeholders.<sup>49</sup>

Uttered 25 years ago, that proposition still holds today. It is not written anywhere that being a corporate lawyer is personally or morally easy.

## VI. PARTNERSHIPS

Another kind of exception to the privity rule is intermediate between liability to third parties for misrepresentation on behalf of a client, and liability to the corporate entity for heeding misguided instructions from corporate officials. This is liability to partners in a partnership or joint venture for following malfeasant instructions from the managing partner.

Liability of this kind can arise in either a general partnership, where all partners are general partners, or in a limited partnership where there is a general partner responsible for active management and the limited partners are more or less passive investors. The tax laws in recent years have created incentives for business ventures to be organized as partnerships rather than corporations, notably avoiding income taxation at the entity level. As a result, the partnership form has become an attractive mechanism for ventures having the classic operational characteristics of the corporation, that is, full-time management administering capital provided by passive investors. By the same token, however, this mechanism creates inherent conflicts between the interests of full-time management and the interests of the investors, similar to the conflicts in the corporate structure.

However, there is a difference in the legal structure of partnerships and corporations that can have significance for a lawyer representing a partnership. A partnership is for various purposes treated as an entity, like a corporation, but for other purposes it is treated as an

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49. *Yablonski v. United Mine Workers*, 448 F.2d 1175, 1181 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 906 (1972).

aggregation of individuals. If the partnership is considered to be an entity, then it is an "organization" within the meaning of Rule 1.13 and the common law principles which that rule reflects. The lawyer's relationship with the client, accordingly, is governed by the rules stated in Rule 1.13, to which reference has already been made. Transposed into the partnership context, these rules are as follows:

- (1) the partnership and not the managing general partner is the client;
- (2) the general partner is an agent of the client and, as such, has duties of loyalty to the client that include refraining from legal harm to the client and avoiding courses of action that threaten to subject the client to serious legal risk; and
- (3) the lawyer must take account of these duties of the managing partner in gauging the conduct and the instructions of the managing partner and those reporting to him.

In summary, the partnership has, in the words of the *Yablonski* decision, "certain . . . institutional interests to be protected."<sup>50</sup> The protector of these institutions' interests often must be the lawyer, who has a client whose affairs are in the hands of nonclients.

The lawyer can be subjected to liability at the instance of the partnership. The risk that liability will be asserted is obviously very small as long as the managing partner retains control. But a managing partner may lose control, for example in bankruptcy. If there is more than one general partner, the manager may be ousted in an initiative by the other partner or partners. And there is authority that limited partners can maintain a derivative suit against faithless managing partners and those who have assisted or improperly acquiesced in the breach of faith.<sup>51</sup> All of these possibilities essentially parallel corporate law. However, as noted earlier, a partnership is also regarded in law as an aggregation of individuals.<sup>52</sup> The concept of an aggregate

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50. *Id.*

51. See, e.g., *Wallner v. Parry Professional Bldg., Ltd.*, 27 Cal. Rptr. 2d 834, 839 (Ct. App. 1994) (holding limited partner may maintain derivative suit against general partners under California Uniform Limited Partnership Act); *Riviera Congress Assoc. v. Yassky*, 223 N.E.2d 876, 879-80 (N.Y. 1966) (holding limited partners may bring derivative suit on behalf of partnership for general partners' breach of fiduciary duty).

52. See *Wagner v. Stratton Oakmont, Inc.*, 83 F.3d 1046, 1049 (9th Cir. 1996) (noting that Uniform Partnership Act of the state of Washington adopts aggregate theory of partnership); *Watt, Tieder, Killian & Hoffar v. United States Fidelity & Guar. Co.*, 847 P.2d 170, 175 (Colo. Ct. App. 1992) (holding that general partnership is not separate legal entity but rather aggregation of individuals). For a discussion of the aggregate theory of partnership, see generally Donald J. Weidner, *A Perspective to Reconsider Partnership Law*, 16 FLA. ST. U. L. REV. 1, 4-10 (1988), which analyzes the tension between the aggregate and entity theories inherent in the Uniform Partnership Act.



applies not only to general partners in a general partnership, but also to limited partners in a limited partnership.

Treating a partnership as an aggregation has two implications for the lawyer's scope of responsibility. First, when the partnership is treated as an aggregation of individuals, it follows that an injury to the collective interest is an injury to the personal interest of each partner instead of being an injury to the entity as such. This proposition holds for injuries inflicted on these interests by one of the members of the group, *i.e.*, the managing partner. Thus, a general partner's wrongful appropriation of a partnership business opportunity is a wrong not simply to the entity, but also to each partner's undivided interest in the venture. Second, and relatedly, it follows that each of the individual partners has standing to sue for such injuries. Third, it could also follow that each of the individual partners is in "privity" with the lawyer. Certainly the linkage between the lawyer and the passive partners is much closer than between the lawyer and complete strangers or "opposite members" in a business transaction.

In this aspect of partnership law, there is no compelling reason why the entity concept should dominate the aggregate concept. The law generally relies on the concept that affords greater protection to the interests of participants in relationships who are at a disadvantage in protecting their own interests. For example, when it comes to liability to third persons for torts arising in the course of the partnership business, the entity concept is invoked to protect limited partners from personal liability because they have no directorial authority over the partnership's activities. On the other hand, when it comes to obligations among the partners *inter sese*, the aggregate theory permits imposing straightforward accountability on the managing partner for misconduct that injures other general partners or limited partners. And the aggregate approach may appropriately govern the accountability of professionals—lawyers, accountants—who have been engaged by the managing partner in conducting the affairs of the enterprise.

The foregoing analysis is somewhat intricate and tedious. That may explain why some judicial decisions and bar ethics opinions have had difficulty articulating the legal basis of malpractice liability of a lawyer whose client is a partnership. Sometimes these difficulties result from poorly conceived causes of action by the aggrieved partners, often apparently the result of fear of the privity barrier. Thus, the cause of action will be predicated on the allegation that the lawyer represented the *claimant*, thereby invoking the image that the lawyer

personally counselled the claimant as well as the managing partner. Proof will be offered that the lawyer never saw the claimant, hence did not "represent" him, hence has no "privity," and hence has no liability.<sup>53</sup>

Other court decisions and bar ethics opinions, however, sense the right result—that where the lawyer assisted the managing partner in acts and omissions legally injurious to the enterprise, the other partners have a right to sue for that wrongdoing. But often the courts and ethics committees get to the result by vague notions: That the other general partners or limited partners are "quasi clients," or that according to a multi-factor test, on balance and all things considered, the lawyer should be treated as responsible for having assisted the managing partner in pillaging the partnership.<sup>54</sup>

What is often forgotten in these vaguely constructed analyses is that a lawyer may undertake representation of a person he has never met, and indeed never meets. Such is the case, obviously, for all lawyers representing a corporation. Consider also a lawyer engaged in this country by a local managing agent of a foreign individual proprietor of a business to carry out a legal task for the foreign citizen. There can be no doubt that the lawyer in this situation represents the foreign citizen notwithstanding that all the communications are through the local agent. Can there be any doubt, also, that if the local agent, with the lawyer's assistance, had diverted assets or opportunities properly those of the foreign client, the lawyer should be legally liable to the foreign client? So too with a partnership: members deal with partnership matters through the managing partner who acts as their agent. Why are not the dealings the same in the relationship with the lawyer?

## VII. LIABILITY WITHOUT PRIVACY

Yet another group of cases have imposed liability on a lawyer to a person who was not a client but to whom the lawyer was held to have

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53. See, e.g., *Kapelus v. State Bar of California*, 745 P.2d 917, 924 (Cal. 1987) (holding no attorney-client relationship existed between lawyer for limited partnership and partners in their individual capacities where each partner had retained outside counsel); *Rose v. Summers, Compton, Wells & Hamburg, P.C.*, 887 S.W.2d 683, 686 (Mo. Ct. App. 1994) (holding attorney representing partnership owes fiduciary duty to entity rather than to individual partners); *Security Bank v. Klicker*, 418 N.W.2d 27, 31 (Wis. Ct. App. 1987) (declining to hold attorney-client relationship existed between a limited partner and counsel for partnership where partner did not retain the attorney, and did not seek out or rely on the advice of the attorney).

54. See *Johnson v. Superior Court*, 45 Cal. Rptr. 2d 312, 316–20 (Ct. App. 1995) (considering various theories for recognizing existence of duty to partners in partnership context).

a special relationship of some kind.<sup>55</sup> These decisions involve various fact patterns and usually are resolved through hesitant and ambiguous judicial pronouncements. The courts sometimes say simply that a “relationship of trust and confidence” had arisen between the lawyer and the injured party who brings the malpractice suit. The challenge here is to think through more precisely the connections between the lawyer and the injured party. The precise challenge is to specify the connections that are, and those that are not, sufficient on which to predicate liability of the lawyer to the injured party.

The courts have been clear that a lawyer should not be liable to a third party, that is, a person who is not the lawyer’s client, where such liability would materially inhibit the lawyer from fulfilling his responsibilities to the client. Indeed, this proposition seems a much better policy touchstone than the concept of contractual or professional privity, as will be explored presently. We have now come to recognize that fraud is a basis for liability of a lawyer to a third person—the law is clearly settled on that point.<sup>56</sup> Accordingly, the problem is not whether a lawyer can, in principle, be liable to persons other than a client. The problem is one of defining the relationships in which the lawyer should, and those in which a lawyer should not, be liable to such persons. Here, an appropriate formulation requires drawing on general legal principles regarding incentives, opportunities, and responsibility.

At this point, it is useful to examine the concept of privity from a functional perspective rather than simply in terms of formal relationship. Concisely stated, the privity concept requires that the lawyer have a lawyer-client relationship with the person who has suffered injury. By definition, this excludes from the circle of legal protection anyone who is not a client. The concept therefore excludes everyone whose welfare might compete with, *i.e.*, be inconsistent with, that of a person who is a client of the lawyer. In effect, the privity rule requires that in a transaction affecting more than one person, any person who is adversely affected and who wishes to pursue a legal remedy must establish his status as a client. However, the privity requirement is over-inclusive in that it requires more than is necessary to protect le-

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55. *See, e.g.*, *Geaslen v. Berkson, Gorov & Levin, Ltd.*, 581 N.E.2d 138, 141 (Ill. Ct. App. 1991) (finding special relationship where client directed attorney to act for benefit of third party); *Schreiner v. Scoville*, 410 N.W.2d 679, 681 (Iowa 1987) (noting trend of relaxing privity requirement when attorney prepares testamentary instruments); *Atlanta Int’l Ins. Co. v. Bell*, 475 N.W.2d 294, 296 (Mich. 1991) (distinguishing between insured and retained defense counsel).

56. *See supra* note 7 and accompanying text.

gitimate client interests and legitimate freedom of initiative on the part of the lawyer.

The basic point is simply stated. In many situations, giving legal protection to a person who is a nonclient does *not* compete with protecting the interests of the lawyer's client or restrict the freedom of the lawyer to take legitimate initiatives on behalf of a client. On the contrary, according protection to the nonclient against the lawyer's misfeasance or malfeasance is often consistent with, and indeed a fulfillment of, the welfare of the lawyer's client.

First, it is clear that there is no reason for withholding liability for deceptive or seriously substandard performance by a lawyer that injured a third person, in circumstances where the proper performance of the lawyer's task would have *fulfilled* the client's purposes. In this category are the "will beneficiary" cases. The prototype was *Biakanja v. Irving*.<sup>57</sup> There, the draftsman, a notary public, botched the will so that the intended beneficiary was deprived of the share of the estate that the client-testator, now deceased, had intended to confer.<sup>58</sup> The California Supreme Court imposed liability.<sup>59</sup> However, the decision referred to a potpourri of factors that gave no clue as to which factors were decisive.<sup>60</sup> The Supreme Court thus reserved to itself the decision of whether liability would or would not be imposed in future situations.

It is difficult to see any reason why a lawyer should not be liable in such a situation. A mechanic who left out a critical part in repairing an automobile would be liable for a wreck subsequently resulting, not only to the car's owner but also to a passenger was well. Why is the lawyer's failure in technique any different? The underlying judicial concern may be anxiety about the very idea that lawyers might be subjected to tort liability for incompetence. However, concern about subjecting lawyers to tort claims, if that is the explanation for judicial hesitancy to impose liability, reflects empathy from the bench that has no place in the disinterested administration of justice.

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57. 320 P.2d 16 (Cal. 1958).

58. *Id.* at 17.

59. *Id.* at 19.

60. The factors mentioned by the court included: the extent to which the transaction was intended to benefit the plaintiff; the foreseeability of harm to the plaintiff; the degree of certainty that the plaintiff suffered harm; the closeness of the connection between the defendant's conduct and the plaintiff's injury; the moral blameworthiness attached to the defendant's conduct; and the public policy of preventing future harm. *Id.*

Most courts have now embraced the result in *Biakanja*, although usually without much improvement on the rationale.<sup>61</sup> As a result, the will beneficiary cases have been regarded as an exception to the privity rule rather than an exemplification of a properly formulated rule. Creating ad hoc exceptions in this way is typical of the path of the common law. However, the time comes when a search should be made for an underlying rationale. Surely it is a satisfactory rationale that a lawyer should be liable to a person, in addition to the client, on whom the client manifested an intention to confer a benefit and who suffered loss of the intended benefit as the proximate result of the lawyer's negligence. That formulation neither extends liability "too far" nor creates incentives that could adversely affect the lawyer's fulfillment of professional obligation to the client.

Notwithstanding that the rationale stated above seems clear enough, the courts have had trouble generalizing the concept implicit in the will beneficiary cases. The Missouri Supreme Court, for example, had to correct its lower courts' inability to see that the *Biakanja* concept should apply to an inter vivos trust, as distinct from a will.<sup>62</sup> The lower court may have speculated that the settlor of the trust could have sued and that the suit was brought by the beneficiary because the settlor had declined to do so. The settlor's disinclination could have been out of pity for the lawyer, or fear of him, or fear of litigation, or the result of a change of mind on the basis that a beneficiary who would sue to enforce a gift was an undeserving sort. However, the settlor's failure to sue could have been simply a consequence of the fact that the settlor was now dead and that his personal representative refused to sue, perhaps because of an alliance in interest with the claimants who would take when the trust was found invalid. There could also be difficulties with the concept and measure of damages in a suit by the settlor. Some of these possibilities might be a basis for a valid *defense* for the lawyer under general principles of law, such as the law of third party beneficiary enforcement of contracts.<sup>63</sup> But giving these factors consideration as defenses is, of course, precluded by the prior interposition of the "privity" rule of immunity.

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61. See, e.g., *Stangland v. Brock*, 747 P.2d 464, 466-67 (Wash. 1987) (holding estate beneficiaries may bring action absent privity under multi-factor test or third party beneficiary theory for will drafting errors); see generally Joseph T. Bockrath, Annotation, *Attorney's Negligence in Connection with Estate, Will or Succession Matters*, 55 A.L.R.3d 977 (1974) (surveying various approaches relied on by state courts).

62. *Donahue v. Shughart, Thomson & Kilroy*, 900 S.W.2d 624, 629-30 (Mo. 1995).

63. See RESTATEMENT (SECOND) OF CONTRACTS § 309 (1979) (listing defenses to claims by third party beneficiaries).

Similar difficulties have been encountered in another group of cases, these involving children. Children do not usually engage lawyers, but rather are the subject of an engagement effected by their parents. The prototype situation is an engagement of the lawyer on behalf of one or both of the parents to carry out a transaction that will affect the child's status. An example is adoption. What if an adoption is botched so that the child fails to become legally the child of the adoptive parents? In the few cases reaching the appellate courts, the judges have sometimes sanctioned the privity defense.<sup>64</sup>

An illuminating decision to the contrary is *Rushing v. Bosse*.<sup>65</sup> There, in holding the lawyers liable in a suit by an adoptive child, the court said:

We do not read [the Florida Supreme Court decision in a will beneficiary case] as creating an exception to the privity requirement limited solely to the area of will drafting. Although privity of contract may create a duty of care . . . lack of privity does not necessarily foreclose liability if a duty of care is otherwise established.<sup>66</sup>

In this case, not only was the child the intended beneficiary of the adoption, but the defendants were the attorneys for the adoptive parents, who evidently intended to benefit the child by adopting her.

#### VIII. LEGAL ADVICE AND ASSISTANCE TO CORPORATE "CONSTITUENTS"

There is, curiously, a situation in representation of corporations that is analytically similar to the "child" cases and as well to the will beneficiary cases. This is where the lawyer for a corporation provides legal advice to corporate employees, officers, or directors (*i.e.*, "corporate constituents"). Such is ordinary practice in the modern corporate setting. For example, an employee may be given advice about whether a report to the government may be signed in the form in which he has drafted it, or whether it requires additional disclosures. An officer may be given advice about the testimony he should give at

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64. See, *e.g.*, *Wilson-Cunningham v. Meyer*, 820 P.2d 725, 730 (Kan. Ct. App. 1991) (holding adult children injured by errors in divorce documentation may not sue attorney); *Michalic v. Klat*, 512 N.Y.S.2d 436, 437-38 (App. Div. 1987) (holding attorneys not liable to biological mother and children for negligence in preparation of adoption papers due to lack of privity between mother and defendant attorneys); *Metzger v. Slocum*, 537 P.2d 74, 76 (Or. 1975) (holding attorney not liable to minor child for legal malpractice for failure to perfect adoption of child because attorney-client relationship existed solely between lawyer and adoptive parents).

65. 652 So. 2d 869 (Fla. Dist. Ct. App. 1995).

66. *Id.* at 873 (citation omitted).

a legislative hearing, or whether he is required on behalf of the corporation to make certain tax payments to the government. Directors routinely are provided advice as to legal aspects of their supervision of the corporation's affairs. A paradigm is advice to directors as to whether a given issue is within, or is outside of, the scope of the business judgment rule governing their authority as a board.

In many such situations, not only the corporation but also the individual constituent is at "legal risk." Regulatory law, for example, increasingly imposes personal liability—sometimes criminal liability—on corporate officials for malfeasance in carrying out legal responsibilities owed by the corporation under a regulatory scheme. Officers are subject to limitations on their freedom of action imposed by the "corporate opportunity" doctrine and other rules. Directors are subject to similar limitations, notably those inherent in the business judgment rule. The violation of such limitations on directors is, after all, what stockholder derivative actions are all about.

In all such situations, the legal advice or assistance is being provided by a lawyer who represents not the addressee of the advice (the director, officer, or employee), but someone else, *i.e.*, the corporation. Of course, separate counsel may be provided to corporate constituents. However, this is done only in unusual situations of obvious legal risk to the constituent or conflict of interest on the part of the corporation's lawyer. What of ordinary situations in corporate life, such as those described above? May the corporate constituent rely on the lawyer's advice or assistance? Is the lawyer legally responsible to the constituent for advice or assistance that was incompetent, biased by a self-protective interest on the part of the lawyer, or otherwise wrongful?

If the privity rule is accepted in its traditional form, the answer to these questions would have to be, "No." The logic is straightforward: The lawyer represented the corporation, not the individual; no lawyer-client relationship arose with the individual; the reliance by the individual was upon advice or assistance provided not by his lawyer, but by a legal stranger; therefore, defense or mitigation based on "advice of counsel" may be unavailing; and, if the advice was negligent or otherwise wrongful, there is no right of redress against the lawyer because of the privity bar.

If this set of legal implications were spelled out to corporate officers or directors, they would surely say that the law is again being, in

Dickens' classic phrase, "a ass."<sup>67</sup> However, if this set of implications were *not* spelled out, an officer or director could rightly complain that, in failing to spell them out, the corporation lawyer has violated Rule 1.13(d). That rule requires that a corporation's lawyer must "explain the identity of the client when it is apparent that the organization's interests are adverse."<sup>68</sup> The interests are adverse if the corporation is mutely holding back (*i.e.*, the lawyer has not explained) that the lawyer present before its constituent, and whom the constituent thinks is providing reliable assistance, is legally a complete stranger to that constituent.

More fundamentally, the director, officer or employee would rightly protest the absurdity of the proposition that the corporation's lawyer is providing advice or assistance, in matters affecting the corporation's affairs, on which these constituents may not personally rely. They would rightly say, "If your advice is not to be relied on, why are we paying you?" The same point, it might be noted, could be made by public officials who have obtained advice from lawyers for government.

In practice, this question arises infrequently. In the first place, a lawyer for a corporation ordinarily has no incentive or interest in contending that he did not represent the corporate director, officer, or other constituent. On the contrary, the lawyer will say that he represented the individual as well as the entity. In the second place, a lawyer for a corporation ordinarily does not have the effrontery to contend that he did not represent the individual to whom the fateful advice or assistance was provided.

In the third place, when the lawyer does have the effrontery to contend that he did not represent the individual, the "client" will testify to facts indicating that the lawyer also represented him, or at least that the "client" reasonably understood that the lawyer did so. The setting of the interchange between the lawyer and the "client" ordinarily will have been sufficiently ambiguous that this testimony raises an issue of fact as to whether the lawyer also represented the individual. Such issues of fact will often be for a jury to decide with consequences that need not be explicated. Even when the issue is before some other trier of fact, the "client" has the benefit of the rule stated in Rule 4.3 of the Model Rules of Professional Conduct. This rule requires the

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67. CHARLES DICKENS, OLIVER TWIST 461 (Kathleen Tillotson ed., Penguin Books 1966) (1838).

68. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(d) (1995). As the comment to Rule 1.13 notes, the unrepresented constituent will often believe the attorney is a "disinterested authority on the law" even while he represents the corporation.



lawyer to clarify the relationship where an “unrepresented person misunderstands the lawyer’s role in the matter.”<sup>69</sup> Hence, the result, as a practical matter, will be that the lawyer is held to have also represented the constituent as an individual. The privity requirement will be satisfied and traditional doctrine will provide no obstacle to getting the right result. That result is, of course, that the corporation’s lawyer was providing advice and assistance on which the individual constituent had a right to rely.

But it is a bad thing that the individual “client” will be forced to sculpt his testimony in order to bring himself under the protection of the law. And there are situations where the individual cannot or will not engage in such post-hoc manipulation of fact. Surely there is no reason why the corporate constituent should be required to distort the facts in order to establish the legitimacy of his reliance on the advice or assistance provided by the corporation’s lawyer. In such circumstances, the corporate constituent should have the benefit of the defense of reliance on advice of counsel, assuming the other elements of the defense are made out.

And so, notwithstanding the privity rule, the corporate constituent should have a right of action against the corporation’s lawyer if the constituent suffered injury as a result of the lawyer’s negligence or other wrongdoing in providing the advice or assistance. That is, he should stand in the same relationship to the lawyer as the will beneficiary, the recipient of a lawyer’s third party opinion, or a child whose life has been adversely affected by the misfeasance of a lawyer engaged by the child’s parents.

#### IX. THE INSURER AS AN INTENDED BENEFICIARY OF A LAWYER’S REPRESENTATION OF AN INSURED

Another variation of relationships where a third party is the contemplated beneficiary of competent service by the lawyer to the client is that where a liability insurer sues defense counsel for having mishandled the defense of the insured. A leading case, *Atlantic International Insurance Co. v. Bell*, holds that the insurer can sue the lawyer for its resulting loss.<sup>70</sup> In some states an exception to the privity rule is not required because the insurer is held to be also a client of the

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69. MODEL RULES OF PROFESSIONAL CONDUCT Rule 4.3 (1995).

70. 475 N.W.2d 294, 297 (Mich. 1991); *see also* American Centennial Ins. Co. v. Canal Ins. Co., 843 S.W.2d 480, 484 (Tex. 1992) (holding insurer may maintain legal malpractice action that could be brought by insured against attorney under theory of equitable subrogation).

lawyer.<sup>71</sup> Whether the latter characterization is appropriate is debatable.<sup>72</sup> It does not seem debatable that the insurer should have standing to sue for the injury it has suffered when the lawyer mishandles the defense of the insured. And if the insurer is held to have standing to sue, then the "exception" to the privity rule is not limited to intra-family matters, such as wills, trusts, and adoptions. Rather, the principle of liability is the more general principle stated in *Rushing v. Bosse*.<sup>73</sup>

Fortunately, in struggling for a rationale, most courts have not used that amorphous phrase as a substitute for the equally amorphous multi-factor test in *Biakanja*. Rather, they have identified the critical elements: Client purpose to obtain the assistance provided by the lawyer; consistency of the claimant's benefit with the client's purpose; specificity of the contemplated beneficiary; and foreseeability of injury.

Thus, the legal proposition is as follows: A lawyer is liable to a third person for the proximate consequences of an act or failure to act that is injurious to a third person if: (1) the injury is a foreseeable result of the lawyer's act or failure to act; (2) the act or failure to act was not in furtherance of conduct or purpose for which the client had legal privilege, justification or excuse, such as the right not to perform a contract obligation, but excluding tortious conduct; and (3) the lawyer has knowledge of facts indicating the foregoing circumstances.

## X. CONCLUSION

In light of the foregoing analysis, it is illuminating to bring into focus the rules of liability that generally are imposed on persons who

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71. See, e.g., *Lysick v. Walcom*, 65 Cal. Rptr. 406, 413 (Ct. App. 1968) (holding that when insured hires attorney to represent insured pursuant to insurance contract, the attorney represents both the insured and insurer); *Rogers v. Robson, Masters, Ryan, Brumund & Belom*, 392 N.E.2d 1365, 1370 (Ill. Ct. App. 1979) (holding that attorney retained by insurer to defend insured has both insured and insurer as clients).

72. See generally Robert E. O'Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511 (1991) (examining issues of conflict of interests arising in insurance defense practice); Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (May 1994) (examining attorney-client relationship in "tri-partite" arrangement of insured, insurer, and defense counsel). See also *State Farm Mut. Auto. Ins. Co. v. Walker*, 382 F.2d 548, 551-52 (7th Cir. 1967) (holding that whether the insured's breach of cooperation was prejudicial to insurer was issue of fact); *Parsons v. Continental Nat'l Am. Group*, 550 P.2d 94, 97-98 (Ariz. 1976) (holding that insurer was estopped from defending garnishment action by denying coverage, where insurer was represented by firm that also represented insured under reservation of rights).

73. See *supra* text accompanying notes 65-66.

act on behalf of others. These rules constitute a legal corpus conventionally called agency law. Under the law of agency, an agent is liable on the following bases:

- To the agent's principal, for assisting someone other than the principal in committing a legal wrong against the principal.<sup>74</sup> This covers situations where the lawyer for a corporation, partnership, or other organization assisted someone, such as an officer or a partner, in a course of action constituting a wrong against the corporation. It would also cover a lawyer who assists in such wrongful conduct against an individual client, situations typically, but not exclusively, involving representation of conflicting interests where the conduct of one client inflicts legal harm on the other.

- To the agent's principal for assisting, or failing to interdict conduct of which the agent is aware and which is within his domain of responsibility, on the part of someone purporting to act for the principal in a course of action that results in the principal's being held legally liable to some third party.<sup>75</sup> This covers situations where the lawyer for an organization assists a corporate officer in such conduct, or fails to intercept such conduct when it has come to the lawyer's attention. The same proposition holds for conduct unfaithful to an individual client.

- To a third person, for providing substantial assistance in fraudulent or otherwise tortious conduct on the part of the principal.<sup>76</sup>

- To a third person, directly or by way of subrogation to the right of the principal, for negligently or intentionally failing to carry out an undertaking on behalf of the principal that was intended to benefit the third person.

This combines a principle of agency law and a principle of third party liability under contract law. Thus, as a general proposition, the appropriate balance of responsibility and immunity for the transaction lawyer is as aptly stated under agency law as it is under the law of privity with its amorphous exceptions. One could well ask, therefore, whether the law's approach would not better treat the law of agency as *prima facie* applicable across the board to transaction lawyers, sub-

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74. See RESTATEMENT (SECOND) OF AGENCY § 391 (1958).

75. *Id.*

76. The *Restatement (Second) of Agency* provides:

An agent who does an act otherwise a tort is not relieved from liability by the fact that he acted at the command of the principal or on account of the principal, except where he is exercising a privilege of the principal, or a privilege held by him for the protection of the principal's interests . . . .

RESTATEMENT (SECOND) OF AGENCY § 343 (1958).

ject to this general exception: *A transaction lawyer should not be liable for injury to a third person resulting from action or inaction in the course of practice if such liability is incompatible with conduct by the lawyer that would further legally permissible or privileged conduct or objectives of the lawyer's client.*

This formulation pretty well corresponds to the law as it has developed. It also has the virtue of focusing attention on the causal consequences flowing from specific lawyer engagements, instead of focusing on the origin of the causal chain in the relationship between lawyer and client. After all, lawyer-client relationships are supposed to further legal objectives, not legally wrongful ones.